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January 30, 2002



# Financial Management

Abnormal Inventory Balances for  
the Navy Working Capital Fund  
(D-2002-045)

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### **Acronyms**

GLAC	General Ledger Account Code
MFCS	Material Financial Control System
NAVICP	Naval Inventory Control Point
WIP	Work-In-Process



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

January 30, 2002

MEMORANDUM FOR NAVAL INSPECTOR GENERAL

SUBJECT: Audit Report on Abnormal Inventory Balances for the Navy Working  
Capital Fund (Report No. D-2002-045)

We are providing this audit report for review and comment. We conducted the audit in support of our audit of the DoD Agency-wide financial statements for FY 2001 as required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Because the Commander, Naval Supply System Command, did not provide comments on the draft report, we request that the Commander comment on the final report by March 1, 2002.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Marvin L. Peek at (703) 604-9587 (DSN 664-9587) (mpeek@dodig.osd.mil) or Mr. Hoa H. Pham at (703) 604-9588 (DSN 664-9588) (hpham@dodig.osd.mil). See Appendix B for the report distribution. The audit team members are listed inside the back cover.

Thomas F. Gimble  
Acting  
Deputy Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

Report No. D-2002-045

(Project No. D2001FC-0140.001)

January 30, 2002

### Abnormal Inventory Balances for the Navy Working Capital Fund

#### Executive Summary

**Introduction.** Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994" October 13, 1994, requires DoD and other Government agencies to prepare annual audited financial statements. This report addresses the abnormal (negative) balances inventory balances reported in the Material Financial Control System by the Naval Inventory Control Point. Inventory is the most significant asset of the Navy Working Capital Fund. As of September 30, 2001, the Navy Supply Management reported Inventory Held for Sale, Net as \$15.9 billion.

**Objectives.** The audit objective was to determine whether the Naval Inventory Control Point (Philadelphia and Mechanicsburg) reconciled general ledger accounts for Inventory On-Hand and Inventory Work-In-Process with the storage activities' logistic records; and whether research was performed to correct differences and abnormal balances. We also evaluated the adequacy of the Naval Inventory Control Point management control program as it related to the audit objective.

**Results.** The Naval Inventory Control Point reported \$438 million of abnormal balances in the March 31, 2001, financial records for the Mechanicsburg and Philadelphia sites. The abnormal balances were recorded in Inventory On-Hand, and Inventory Work-In-Process. During the audit, personnel at the Mechanicsburg and Philadelphia sites took actions to correct \$184.6 million of abnormal balances for both the Inventory On-Hand and Inventory Work-In-Process general ledger accounts. The remaining \$253.4 million in abnormal balances required extensive research to determine when and how the abnormal balances occurred, and therefore, will need to be corrected at a later date. However, until improvements in the reconciliation process and internal controls are made, the problems will recur and will adversely affect management decisions. In addition, note 9A to the FY 2001 financial statements prepared for the Navy Working Capital Funds could be misstated.

**Summary of Recommendation.** We recommend that the Commander, Naval Supply Systems Command, establish appropriate internal controls to ensure that financial inventory records are periodically evaluated for unusual or questionable conditions. We also recommend that Naval inventory reconciliation procedures be revised to ensure that reconciliations are performed at the detailed level and abnormal and unusual balances found in the financial records are fully researched and documented. Further,

we recommend the Commander, Naval Supply System Command, review and determine staff needed for the reconciliation to ensure that the revised reconciliation is fully implemented. We recommend that the Naval Inventory Control Point, Mechanicsburg and Philadelphia sites, continue to research, resolve, and fully document the corrective actions for the remaining abnormal balances.

**Management Comments.** The Commander, Naval Systems Supply Command, did not submit comments for the draft report dated November 16, 2001. Therefore, we request that the Commander provide comments in response to the final report by March 1, 2002.

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## Background

Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires DoD and other Government agencies to prepare annual financial statements. The Inspector General, DoD, is responsible for auditing DoD agency-wide financial statements. The Navy Working Capital Fund is one of the eight DoD Component reporting entities within the Department of Defense required by the Office of Management and Budget to prepare stand-alone audited financial statements. As of March 31, 2001, the Naval Inventory Control Point reported approximately \$32.8 billion (standard price) as the inventory of reparable and consumable items.

**Naval Inventory Control Point.** The Naval Inventory Control Point (NAVICP) manages inventory that is stored at DoD and Navy Depots, on Navy ships, and at contractor sites around the world. The NAVICP is one organization with two locations in Pennsylvania—Mechanicsburg and Philadelphia. The NAVICP performs inventory accounting functions for Navy Working Capital Fund material managed by NAVICP. Each month, NAVICP performs inventory reconciliations between the logistic records and financial records.

**Guidance for Reconciling Inventory Line Items.** NAVSUP P-723, "Navy Inventory Integrity Procedures," April 2000, requires the Inventory Accuracy Department to ensure accurate maintenance of inventory records and the financial reflection of inventory records in the Master Data File and Financial Inventory Control Ledger respectively. The regulation also requires that the Inventory Accuracy Department perform trend analysis of various areas to identify, develop, and implement required changes to resolve problem areas that impact inventory accuracy.

**Material Financial Control System.** The Material Financial Control System (MFCS) records financial data at the inventory control point and provides input to the Defense Finance and Accounting Service Central Data Base for the preparation of the financial statements. The MFCS is the financial control application of the Uniform Inventory Control Program System. Three modules comprise the system: Inventory Accounting and Billing (PX06); Allotment Accrual Accounting (PX02); and Expenditure Processing (PX04). The MFCS is a mixed system providing both logistical and financial support. The ST1070 is the asset record contained within the Inventory Accounting and Billing module (PX06) and it is used during the inventory reconciliation process.

## Objectives

The objective was to determine whether the Naval Inventory Control Point (Philadelphia and Mechanicsburg) reconciled General Ledger Accounts Inventory On-Hand and Inventory Work-In-Process (WIP) with the storage



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activities' logistic records; and whether research was performed to correct differences and abnormal balances. We also reviewed the adequacy of the Naval Inventory Control Point management control program as it related to the audit objective. Appendix A discusses the audit scope and methodology and our review of the management control program.

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## Reporting Abnormal Inventory Balances

The NAVICP reported \$438 million of abnormal balances for inventory in the March 31, 2001, MFCS general ledger for its Mechanicsburg and Philadelphia sites. A review of \$390.9 million of the \$438 million (89 percent) of abnormal balances showed that the abnormal balances reviewed occurred because:

- NAVICP had not established controls to periodically evaluate historical financial inventory records to detect and correct unusual, questionable conditions, or repetitive problem patterns as required;
- procedures for reconciling logistics and financial records for inventory were performed at the summary level and were not thorough enough to detect abnormal balances that occurred at the detailed level; and
- the reconciliation process matched financial records to the logistic records and, thus, did not ensure accurate maintenance of financial inventory records.

During the audit, command personnel at the Mechanicsburg and Philadelphia sites took actions to correct \$184.6 million of abnormal balances for both the Inventory On-Hand and Inventory Work-In-Process<sup>1</sup> general ledger accounts. The remaining \$253.4 million in abnormal balances required extensive research to determine when and how the abnormal balances occurred and, therefore, will need to be corrected at a later date. Until improvements in the reconciliation and internal controls are made, the problems will recur and can adversely affect management decisions. The abnormal balances reported in the MFCS may not materially affect the “net inventory” line item in the FY 2001 financial statements because those abnormal balances are netted against other positive balances for the total inventory line item. However, detailed information, as shown in note 9A to the financial statements, could be misstated.

### Abnormal Inventory Balances

The NAVICP Mechanicsburg and Philadelphia sites reported \$438 million in abnormal inventory balances for the Inventory On-Hand general ledger account code (GLAC) 152131 and for the Inventory WIP GLAC 152321, 152322, 152323, and 152324 as of March 31, 2001. Review of \$390.9 million of the

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<sup>1</sup> We use “Work-In-Process” interchangeably with “Held for Repair” inventory because report data is taken from the Navy accounting systems. The U.S. Government Standard General Ledger defines “Work-In-Process” as unfinished products during manufacturing and “Held for Repair” as finished inventory undergoing repair. However, the Navy accounting systems use the Inventory Work-In-Process account to include Inventory Held for Repair.

\$438 million in abnormal balances showed that \$46.0 million had been recorded as abnormal balances prior to FY 1998 and the remaining \$344.9 million were recorded as abnormal balances between FY 1998 and March 31, 2001, as shown in Table 1. We did not determine how long the remaining \$47.1 million in abnormal balances had been reported. However, these abnormal balances will also have to be researched and resolved.

<b>Table 1. Results of the Review of \$390.9 Million in Abnormal Balances (millions)</b>			
	<u><b>Mechanicsburg</b></u>	<u><b>Philadelphia</b></u>	<u><b>Combined Total</b></u>
<b>Prior to 1998</b>	\$ 0.1	\$ 45.9	\$ 46.0
<b>1998</b>	20.6	10.6	31.2
<b>1999</b>	7.1	177.8	184.9
<b>2000</b>	3.4	114.3	117.7
<b>2001</b>	2.1	9.0	11.1
<b>Total Reviewed</b>	<b>\$33.3</b>	<b>\$357.6</b>	<b>\$390.9</b>

The normal balance for an account is always positive. However, if an account goes below \$0 it becomes a negative balance and therefore is abnormal. An abnormal balance represents more decreases to an account than increases and generally indicates a reporting anomaly that requires explanation. If uncorrected, abnormal balances may distort the integrity of the financial information. Also, management decisions may be impaired if decisions are based on the accuracy of the reported balances.

## **Reasons for Abnormal Balances**

The lack of established controls to periodically evaluate historical financial inventory records to detect and correct unusual, questionable conditions or repetitive problem patterns in a timely manner was the primary cause of abnormal balances. Also, reconciliation procedures that were limited to the summary level did not identify and correct errors in the financial inventory records, which contributed to the continued reporting of abnormal balances in the MFCS.

**Compliance With Reconciliation Guidance.** NAVICP Organizational Manual, March 18, 1998, requires the Inventory Accuracy Department to periodically evaluate historical financial inventory records for unusual, questionable conditions or repetitive problem patterns to resolve and document the reasons

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for the problems. As of March 31, 2001, the NAVICP's financial records reported \$438 million in abnormal balances for the Inventory On-Hand and Inventory WIP general ledger accounts managed by the Mechanicsburg and Philadelphia sites. However, the NAVICP had not established adequate controls to review the financial inventory records to identify and determine the specific causes of the reported abnormal balances. According to NAVICP accounting officials, the problem was recognized in prior fiscal years but they did not have resources to investigate the problem. We agree that a comprehensive review of historical financial data will require time and effort. However, the inability to determine where, when, and how the problems occurred highlights the need for continuous and timely review of abnormal and unusual account balances. Also, researching the causes of abnormal balances becomes more difficult and time consuming if errors go unresolved for long periods of time.

**Reconciliation Procedures.** DoD Regulation 7000.14-R, "Financial Management Regulation," volume 11B, "Reimbursable Operations, Policies and Procedures-Working Capital Funds," December 1994, chapter 55, requires that inventory line item accountability records be reconciled to general ledger inventory accounts on a quarterly basis. The regulation further states that differences between inventory line item accountability records and general ledger accounts shall be investigated to determine the cause(s) of the differences. Both Mechanicsburg and Philadelphia performed monthly reconciliations as required. However, improvements in the reconciliation procedures were needed to ensure that abnormal balances or unusual balances in the financial records were identified, detected, and corrected. The existing reconciliation procedures were performed at the summary level and were not thorough enough to detect the abnormal balances that occurred at the detailed level.

For example, on March 31, 2001, the financial records showed that a total of \$3.9 million for Inventory WIP (GLAC 1523) was maintained at Lockheed Martin commercial repair facility. During the reconciliation process, this amount corresponded with the supply records; therefore, no action was taken. However, further review of the financial records at the detailed level showed that the \$3.9 million for Inventory WIP (GLAC 1523) was the summation of negative \$4.9 million for Inventory WIP Contractor (GLAC 152322) and \$8.8 million for Inventory WIP Government (GLAC 152321). The \$4.9 million abnormal balance was not detected and corrected during the monthly reconciliation because the reconciliation process did not take into account information at the detailed level. Consequently, it was difficult to identify abnormal balances. Table 2 provides an example of the deficiency in the reconciliation procedures.

<b>Table 2. Example of the Reconciliation for Inventory Work-In-Process</b>				
	<u>Logistical Record</u>	<u>Financial Record</u>		
<u>Lockheed Martin – Alabama</u>	<u>Balance</u> (million)	<u>Balance</u> (million)	<u>GLAC</u>	<u>Balance</u> <u>Difference</u>
Inventory WIP – Government		\$ 8.8	152321	
Inventory WIP – Contractor		(4.9)	152322	
<b>Total Inventory WIP<sup>1</sup></b>	<b>\$ 3.9</b>	<b>\$ 3.9</b>	<b>1523</b>	<b>\$0</b>
<sup>1</sup> Currently, the logistical data for the reconciliation process is not retrieved at the detailed level of Inventory WIP Government or Contractor. It is only extracted from the logistical records as total Inventory WIP, which makes it difficult to identify abnormal balances in the financial records at the detailed level.				

Command personnel at both sites stated that abnormal balances continued for long periods of time because current reconciliation procedures were only concerned with the net value of the inventory balances. Also, they added that the abnormal balances recorded in Inventory On-Hand (GLAC 152131) and Inventory WIP (GLAC 152321, 152322, 152323 and 152324) had little impact in the financial statements because those balances were netted against other positive balances for the total inventory line item.

**Matching Financial Records to Supply Records.** The existing reconciliation procedures were inadequate to detect abnormal balances or unusual balances because the process matched financial records to supply records. To speed up the reconciliation process, the Inventory Accuracy Department developed a program to automatically match the financial record to the supply records. The program compared the unreconciled Inventory On-Hand in the financial records to the Master Item File of the supply records. If the financial records and supply records each had different balances, the program would automatically create an unreconciled balance value listing. Therefore, the accountants would only need to research and resolve unreconciled balances generated by the reconciliation program. However, if the amounts in both supply records and financial records agreed, either positive or negative, the program would not create an unreconciled balance. Accordingly, no reconciliation or action appeared to be needed. As a result, abnormal balances could go undetected for long periods of time. Table 3 shows an example of the reconciliation for the Inventory On-Hand.

Table 3. Example of Reconciliation for Inventory On-Hand				
	Logistical Record	Financial Record		Balance Difference
	Balance	Balance	GLAC	
Norfolk Naval Air Station				
Total Inventory On-Hand	\$(12,238)	\$(12,238)	152131	\$0 <sup>1</sup>
<sup>1</sup> . No unreconciled balance was created because the financial record and the logistic record agreed. Accordingly, the accountant did not review the \$12,238 in abnormal balances.				

## Effects of Abnormal Balances

**Impact on Note 9A to the Financial Statements.** Abnormal balances which occurred in the inventory subsidiary accounts of Inventory On-Hand and Inventory WIP had little impact on the net inventory line item because they could be netted against other positive balances. However, if the abnormal balances are not corrected, those balances, when shown in note 9A to the financial statements, could cause the amounts reported in Inventory WIP to be understated and the amounts reported in Inventory On-Hand to be overstated. For example, as of March 31, 2001, the financial records showed Inventory WIP-Government Furnished Material (GLAC 152324) had a negative balance of \$170 million. During the audit, accounting personnel performed research and determined that the problem occurred because accounting personnel erroneously posted various transactions related to Inventory WIP-Government Furnished Material (GLAC 152324) to Inventory On-Hand (GLAC 152131). Those posting errors created \$170.6<sup>2</sup> million in abnormal balances for GLAC 152324. Based on the results of the research, accounting personnel made a reversing entry to correct the errors. If these errors had not been corrected, FY 2001 note 9A to the financial statements for the Inventory On-Hand (GLAC 152131) would have been overstated by \$170.6 million, and Inventory WIP-Government Furnished Material (GLAC 152324) would have been understated by \$170.6 million. The remaining \$253.4 million in abnormal balances could have the same effect on note 9A if not corrected.

**Management Decisions.** The abnormal balances reported in the MFCS can adversely affect other management decisions that are based on the accuracy of the reported balances. According to accounting officials at the Naval Supply System Command and NAVICP, the MFCS is widely used by various activities within the Naval Supply System Command and NAVICP for management

<sup>2</sup> The Abnormal balances reported in the MFCS for GLAC 152324 increased from \$170 million on March 31, 2001 to \$170.6 million on April 30, 2001.

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decisions, such as budgeting, accounting, or procuring inventory at the Navy depot levels. Therefore, inaccurate inventory balances impact the calculation of supply requirements and could adversely affect budgeting, accounting, and other management decisions.

## **Corrective Actions Taken by NAVICP**

After being informed of large abnormal balances, command personnel at Mechanicsburg and Philadelphia performed research, identified the reasons for some of the abnormal balances and successfully reduced the total from \$438 million reported in the March 31, 2001, financial records to \$253.4 million. The remaining \$253.4 million in abnormal balances will require extensive research. Command personnel at both sites were unable to determine when and how the problems occurred because the problems had gone undetected for long periods of time.

Also, to compensate for the constrained resources, the Inventory Accuracy Department has requested that the Fleet Material Support Office initiate a program that reports all credit balances monthly. This report will alert the reconciliation team to determine whether the abnormal balances must be researched and resolved. In addition, the NAVICP states in its FY 2001 Management Control Evaluation that they will develop a plan to reconcile the existing backlog of on-hand ledgers with value less than zero; and review, identify and resolve any new occurrences on a monthly basis.

## **Conclusion**

The inability to detect and correct the \$438 million in abnormal balances for long periods of time highlights the need for continuous and timely review of financial inventory records for credit and unusual account balances. A timely review of abnormal and unusual account balances is needed because researching the causes of abnormal balances is difficult and time consuming if errors go unresolved for long periods of time. Abnormal balances reported in the MFCS did not appear to impact the net inventory line item in the FY 2001 financial statements because those abnormal balances are netted against other positive balances. However, detailed information as shown in note 9A to the financial statements could be misstated. Also, allowing the abnormal balances to go uncorrected can adversely affect management decisions that are based on the accuracy of the reported balances. Considering the magnitude of the \$438 million in abnormal balances, we believe that the NAVICP should revise its policy on the reconciliation procedures to ensure that the reconciliation is performed at the detailed transaction levels and not just the summary levels. Also, the revised policy should emphasize the need to evaluate historical financial inventory statistics for unusual or questionable conditions such as credit balances, abnormal charges, and ledgers without activity.

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## **Recommendations**

We recommend that the Commander, Naval Supply Systems Command:

1. Establish appropriate controls to ensure that financial inventory records are periodically evaluated for unusual or questionable conditions such as credit balances, abnormal charges, ledgers without activity, or repetitive problem patterns.
2. Revise the current reconciliation procedures to require accountants to reconcile at the summary and detail account levels.
3. Review and determine the staff necessary to fully implement the revised reconciliation procedures.
4. Complete and fully document the corrective actions for the remaining abnormal balances.

## **Management Comments Required**

The Commander, Naval Systems Supply Command, did not comment on this report. We request that the Commander provide comments on the final report.



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## Appendix A. Audit Process

### Scope

We reviewed the procedures and controls used by the NAVICP to account for the inventory balances recorded in the MFCS. Specifically, we reviewed the \$438 million of abnormal balances reported for Inventory On Hand GLAC 152131, and Inventory WIP GLAC 152321, 152322, 152323, and 152324 in the March 31, 2001, MFCS. As of March 31, 2001, the NAVICP reported approximately \$32.8 billion (standard price) for the inventory of reparable and consumable items. We reviewed the reconciliation procedures and initiatives made by the Naval Inventory Control Point accounting personnel to research and correct the abnormal balances. We also reviewed the adequacy and the completeness of the current reconciliation procedures.

**General Accounting Office High-Risk Area.** The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the financial management high-risk area.

### Methodology

We reviewed applicable laws, policies, procedures, and regulations related to the controls over inventory balances reported in the supply system and in the financial system. We reviewed \$390.9 million of the \$438 million of abnormal balance reported in the March 31, 2001, MFCS general ledger for the Mechanicsburg and Philadelphia sites to determine where, when, and how the abnormal balances occurred. We reviewed the Naval Inventory Control Point reconciliation procedures to determine whether the reconciliation procedures were performed in accordance with applicable guidance and the reasons why the abnormal balances were not identified and corrected. Also, we visited, performed audit work, and held discussions with personnel responsible for the accuracy of the inventory information at Naval Inventory Control Point, Mechanicsburg and Philadelphia.

**Use of Computer-Processed Data.** We relied on computer-processed data from the Uniform Inventory Control Program System, and the Material Financial Control System to conduct this audit without testing the reliability of the data. Also, we did not perform tests of the system's general and applications controls. Because we did not attest to the accuracy of the inventory balances, our use of the data did not affect the results of the audit.

**Audit Type, Dates, and Standards.** We performed this financial-related audit from May 2001 through October 2001 in accordance with generally accepted Government auditing standards.

**Contacts During the Audit.** We visited or contacted individuals and organizations in DoD. Further details are available on request.

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## Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provide reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

**Scope of the Review of the Management Control Program.** We reviewed the adequacy of the NAVICP management controls over supply/financial reconciliation. Specifically, we reviewed NAVICP management controls over detecting, researching, and correcting abnormal inventory balances. Our review involved reviewing management's self-evaluation applicable to those controls.

**Adequacy of Management Controls.** We identified material management control weaknesses for NAVICP as defined by DoD Instruction 5010.40. NAVICP Inventory Accuracy Department management controls were not adequate to ensure that abnormal balances are detected, researched, and corrected in a timely manner. The financial reconciliation process was designed to detect errors at the summary levels for Inventory On-Hand and Inventory WIP accounts. This process does not always identify abnormal balances at the detailed levels. Also, the Inventory Accuracy Department did not periodically evaluate historical financial records for unusual and questionable conditions as required. Recommendations 1 and 2, if implemented, will improve procedures to identify abnormal balances. A copy of the report will be provided to the senior official in charge of management controls for the NAVICP.

**Adequacy of Management's Self-Evaluation.** NAVICP Inventory Accuracy Department management identified supply and financial reconciliation as an assessable unit. The organization no longer identifies the level of risk. However, the organization did state in its FY2001 Management Control Evaluation that controls were not adequate in identifying abnormal balances in a timely manner.

## Prior Coverage

No prior coverage has been conducted in the specific subject of this audit. However, the General Accounting Office; the Inspector General, DoD; and the Naval Audit Service have conducted multiple reviews related to the inventory issues. General Accounting Office reports can be accessed on the Internet at <http://www.gao.gov>. Inspector General, DoD, reports can be accessed on the Internet at <http://www.dodig.osd.mil/audit/reports>. Naval Audit Service reports can be accessed on the internet at <http://www.hq.mil/navalaudit>.

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## **Audit Team Members**

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel of the Office of the Inspector General, DoD, who contributed to the report are listed below.

Paul J. Granetto  
Marvin L. Peek  
Hoa H. Pham  
Vanessa S. Adams  
Brian Benner  
Lashonda Thompson  
Melanie Ulloa